No. 3091.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

CLARA M. WIGHT and OTIS B. WIGHT (her husband), and GERTRUDE M. GREGORY and T. T. C. GREGORY (her husband),

Appellants,

vs.

WASHOE COUNTY BANK (a Corporation), et al.,

Appellees.

APPELLEES' BRIEF

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Filed this.....day of April, A. D. 1918.

F. D. MONCKTON, Clerk.

By.....Deputy Clerk.

The James H. Barry Co., San Francisco.

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APPELLEES' BRIEF.

The appellants' statement of the case either does not mention, or fails to give, due prominence to many important facts shown by the record, which will be referred to in the course of this discussion.

THIS COURT SHOULD NOT ENTERTAIN THIS SUIT BECAUSE IT IS FOUNDED ON AN ALLEGED ILLEGAL AGREEMENT.

It is a maxim that he who comes into a court of equity must come with clean hands. No person who bases his right upon an illegal contract, or one against

public policy will be heard to complain when he seeks relief from a situation created thereby.

In the amended complaint, paragraph XII, the plaintiff alleges that the stock in question was transferred by the Martin Estate Company into the name of Harry M. Martin "for the purpose only of qualifying the said Harry M. Martin to become a director of the said defendant Washoe County Bank."

The laws of Nevada at all times in controversy in this case required that a director of a corporation be a stockholder.

1 *Revised Laws of Nev.,* Sec. 1223.

By repeated decisions of the Supreme Court of Nevada, it is established that the necessity that a director be a stockholder is imperative. Not only is it necessary that a director be a stockholder, but it is also held that when a director ceases to be a stockholder, he *ipso facto* ceases to be a director. Not only is it illegal for one not a genuine stockholder to be a director of a corporation, but it is also against public policy. Only those who have a genuine and substantial financial interest in a corporation should be entrusted with a share in its management.

If the alleged contract or arrangement between the Martin Estate Company and Harry M. Martin, with reference to the fifty shares of stock in question, is either inherently illegal or is against public policy, these plaintiffs can obtain no relief in this case.

In order to recover in this case it is necessary for the plaintiffs to prove this illegal agreement between the Martin Estate Company and Harry M. Martin, and also to prove that the bank had notice of it.

The findings of the Court, after an analysis of the testimony, were against the plaintiffs on this contention, but it is still the duty of counsel to direct the attention of the Court to the fact that the plaintiffs' case is founded on an illegal agreement in order that the Court itself may be advised of the nature of the contract it is expected to enforce and take such action as to it may seem fit.

The plaintiffs' complaint alleges in effect that Mr. Harry M. Martin in fact was not the owner of the fifty shares of stock in question, but that it at all times belonged to the Martin Estate Company. The stock was transferred to Harry M. Martin to cause it to appear that he was a genuine stockholder in the Bank, whereas, in truth and in fact, he was not. He was to be purely and simply a "dummy" director. If this be true, a court of equity will leave the parties to such a transaction exactly where it finds them.

The Courts of the United States are substantially unanimous upon the proposition that there can be no recovery upon an illegal contract.

We cannot agree with the contention that this agreement pleaded in the complaint was not illegal and even fraudulent. The business success and financial standing of a bank rests upon the confidence which

the public has in its affairs being entrusted to the management of those who are interested in its welfare. To allege and publicly proclaim that the managing officers of a bank have been party to an agreement for the election of a "dummy" director, of itself would seriously impair the Bank's standing, and when, in addition to this, the fact that the director is a "dummy" is concealed and he is permitted not only himself to vote the stock at stockholders' meetings as a *bona fide* stockholder, but also the party who makes this charge appears as his proxy and votes that stock as being the stock of Harry M. Martin, it is such a deception and misrepresentation to the other stockholders and such a suppression of the truth as to constitute a fraud upon the Bank and its stockholders. If it was legal for the Bank to have one "dummy" director, it would likewise be legal for it to have seven, the entire Board. In such case the entire management of the Bank would be entrusted to people who had no pecuniary interest in its welfare in disregard of the rights and interests of depositors and stockholders. The legislative requirement that a director should be a stockholder declares the public policy to be that the affairs of a Bank shall be controlled by those who are interested in its welfare.

Surely the suggestion of the trial judge that these plaintiffs, suing as stockholders of the Martin Estate Company to enforce an agreement alleged to have been made by the Martin Estate Company for the benefit

of the Martin Estate Company, have a different standing in this suit than Martin Estate Company, must have been inadvertently made.

According to the contentions of the plaintiffs, the transfer of this fifty shares of stock to Harry M. Martin was simply an idle ceremony. If their statement is true, and it is the basis of their case, Harry M. Martin was not a stockholder in the Bank at the time he was chosen as a director. It should be remembered that this is not an action of *quo warranto* to test the legality of corporate action by the Bank on the ground that it was brought about through the action of a director illegally elected. It is an appeal to a Court of Equity by a participant in an illegal transaction for relief from its consequences.

The Federal Courts have never deviated from the rule that denies recovery to a litigant who bases his cause of action upon an illegal contract when, in order to recover, he must prove the contract. It is the duty of Courts, so the decisions say, to enforce the law and in no manner to countenance the breaking of the law.

Bank of the U. S. vs. *Owens, et al.,* 2 Peters, 537.

We quote briefly from this decision:

> "The question then is, whether such contracts are void in law, upon general principles.
>
> "The answer would seem to be plain and obvious, that no court of justice can in its nature be made the handmaid of iniquity. Courts are insti-

tuted to carry into effect the laws of a country; how can they then become auxiliary to the consummation of violations of law?

"To enumerate here all the instances and cases in which this reasoning has been practically applied, would be to incur the imputation of vain parade.

"There can be no civil right where there can be no legal remedy; and there can be no legal remedy for that which is itself illegal."

Pullman Palace Car Co. vs. *Central Transportation Co.,* 171 U. S., 137;
Primeau vs. *Granfield,* 193 Fed., 911.

The Supreme Court of Nevada takes the same ground as the Federal Courts.

Gaston vs. *Drake,* 14 Nev., 175;
Drexler vs. *Tyrrell,* 15 Nev., 114-31-34;
Peterson vs. *Brown,* 17 Nev., 172-7.

We think the case at bar comes within the decision of the Court of Appeals of the State of New York where the Court uses this language:

"When we consider the provisions of the statute and the by-law over against the very general practice of qualifying persons for the offices of directors or trustees in stock corporations, it is going quite far enough to hold that when a transfer of stock is made for that purpose in good faith, and the transferee actually holds the stock during his incumbency of office, such transferee is a stockholder, within the purview of the law. But that is not the case at bar. When Trommer, Strauss, and Kugel-

man took their respective assignments of stock, it was with no thought of holding it, even until they were elected; for they at once retransferred the stock to the owner. It was simply a fictitious transfer, by which it was thought to comply with the naked letter of the law. . . .

"It seems to us to be going quite far enough to permit a person to become qualified for the office of director or trustee in a stock corporation by the mere transfer to him of a sufficient number of the shares of its stock, if he actually takes and holds it during his term of office. To go further would be to place a premium upon fictitious and colorable transactions designed in form to comply with the law and in fact to defeat its commands."

In re George Ringler & Co., 204 N. Y., page 30, 97 N. E., 593.

Of course, this Court will confine its review to the errors assigned by the appellants. From that assignment (Tr., p. 64) it appears that only two errors are relied upon by the appellants on this appeal, namely:

First—That the Washoe County Bank, before it made its loan to H. M. Martin, had notice that the fifty shares of bank stock, standing on the books of the Bank in the name of Harry M. Martin, was not his stock but the stock and property of the Estate of W. O'H. Martin, Incorporated;

Second—That the District Court erred in holding that the failure of the Washoe County Bank to produce George H. Taylor, its Assistant Cashier, as a witness, did not create a presumption unfavorable to

said Bank for the reason that said Taylor, though available to both plaintiffs and defendants as a witness, was a person hostile to said plaintiffs.

THE WASHOE COUNTY BANK, WHEN IT MADE ITS LOAN TO HARRY M. MARTIN, HAD NO NOTICE OF THE CLAIMS OR EQUITIES OF THE MARTIN ESTATE COMPANY.

In the Fall of 1906, Harry M. Martin, who had formerly been a Director of the Bank (Tr., p. 150), had resigned and moved from Reno to Tonopah, and was then indebted to the Bank over Twenty-two Hundred ($2200.00) Dollars (Tr., p. 153), and desiring to get a further loan from the Bank, wrote to George H. Taylor (Tr., pp. 124, 150), at which time said Taylor was the confidential agent and bookkeeper of the Martin Estate Company (Tr., pp. 106, 108, 128), requesting him to get a loan from the Bank for Harry M. Martin, to which Mr. Taylor replied that it would be satisfactory.

On November 24th, 1906, a loan of Fifteen Thousand ($15,000.00) Dollars by the Bank to Harry M. Martin was allowed by the Board of Directors and on November 24th, 1906, Harry M. Martin gave his note to the Bank for Seventeen Thousand Five Hundred ($17,500.00) Dollars, and in 1909 he gave the Bank a renewal note for the principal and interest, amounting to Twenty Thousand One Hundred and Fifty-one Dollars and Sixty-four Cents ($20,151.64),

no part of which has ever been paid (Tr., pp. 125, 152, 153, 154).

A By-Law of the Bank provides that no transfer of stock shall be made upon the books of the corporation until after the payment of all indebtedness due to the banking corporation by the persons in whose name the stock stands on the books of the corporation, except with the consent in writing of the President. This provision of the By-Laws was printed upon each certificate of stock issued by the corporation (Tr., pp. 18, 152).

It is true that it has been held that a regulation which provided that

> "No such stock shall be transferred, the holder thereof being indebted to the Bank, until such debt can be satisfied."

did not create a lien, when the Bank knew that the holder of the stock was not the real owner.

Mechanics Bank vs. *Seton,* 1 Pet., 308.

The By-Law to be construed in this case is materially different from the statute before the Court in the Seton case. The manifest purpose of the Washoe County Bank in adopting the By-Law in question was to make the test, not whether the person for whose indebtedness the Bank claimed a lien was the *holder* of the stock, but solely whether it *stood* upon the *books* of the Company *in his name.* It thereby gave notice to every stockholder that if he permitted any of his

stock to stand upon the books of the Company *in the name of another,* that stock was liable and the Bank had a lien upon it for the debt of the person in whose name it stood, and that until that debt was paid, or the consent provided for in the By-Laws obtained, that stock could not be transferred.

The Bank's stockholders had the right to make this By-Law and create a lien on the stock for any indebtedness of the person in whose name it stood on the books of the Company.

Cutting's Compiled Laws (Nevada), Sec. 869;
1 *Boles on Banking,* Sec. 24;
Pendergast vs. *Bank,* 2 Sawyer, 109; 19 Fed. cases, 135.

Stockholders are conclusively presumed to know the By-Laws of the Bank.

3 *Clark and Marshall on Corporations,* Sec. 577, p. 1763;
Jennings vs. *Bank of California,* 21 Pac., 852.

The By-Law and stock certificate notified the Martin Estate Company that if they permitted that stock to remain upon the books of the Bank *in the name of Harry Martin,* whether he had any interest therein or not, or whether the Bank knew that he had any interest therein or not, it would still be subject to the Bank's lien for any debt of Harry M. Martin, and that the Bank was without authority to transfer

it until that indebtedness was paid, unless he obtained the written consent of the President. Such a provision enabled the Bank to rely solely upon its record to ascertain for whose indebtedness it had a lien upon the stock, and may wisely have been intended to relieve the Bank from all controversies respecting the ownership of the stock.

The testimony is clear that this stock was placed in Harry Martin's name on the books of the Bank at the request and for the sole benefit of the Martin Estate Company. Having received the benefit of placing this stock on the books of the Bank in Harry Martin's name, it ought not to complain if it had to bear the consequences of so doing, especially when the situation is of their own creation.

The Bank claims that it had no notice before it made the loan (Tr., pp. 14, 15), and the trial Court so found (Tr., p. 50).

Upon this point there is a direct conflict of testimony. Mrs. Martin, the mother of Harry Martin, and the President and principal stockholder of the Martin Estate Company, testified that she had conversations, in 1903, with Messrs. Mapes, Bender and Rowland, who were then officers and directors of the Washoe County Bank, by which they agreed, or consented, that Harry Martin might be appointed a director of the Bank if she caused stock of the Bank to stand in his name upon the books of the Company without his being the real owner of the stock. Her

testimony is not only without corroboration, but is explicitly denied by each of these three gentlemen who state that they never knew that the stock standing in Harry Martin's name did not belong to him or was claimed to be owned by the Martin Estate Company until 1909, or later, and that they never consented and would not have permitted Harry Martin to be appointed or elected as a director of the Washoe County Bank if they had supposed, or had any knowledge, that he was not the real owner of that stock (Tr., pp. 150, 151, 156, 157).

Mrs. Martin testified, with equal positiveness, that the only reason why she put as much as fifty shares of stock in the name of Harry Martin, to qualify him as a director, was that the three hundred shares of stock which the Martin Estate Company then had in the Washoe County Bank was represented by two certificates, one for two hundred and fifty shares, and one for fifty shares, and that, as a matter of convenience, she had the certificate for fifty shares transferred to the name of Harry M. Martin (Tr., pp. 88, 89, 90, 91, 118). But it became very manifest that her memory was not reliable when it was shown by the books of the Bank that when she caused the fifty shares of stock to be put in the name of Harry M. Martin all the stock theretofore owned by the Martin Estate Company was represented by one certificate of three hundred shares, which, over her own signature, she that day surrendered and had cancelled and

caused two new certificates to be issued, one for two hundred and fifty shares in the name of the Estate of W. O'H. Martin, Incorporated, and the other for fifty shares in the name of Harry M. Martin (Tr., pp. 146, 147).

It must, therefore, be manifest to this Court that the findings of the trial Court that the Bank did not have notice of the claim of the Martin Estate Company to the stock in question is sustained by the great preponderance of the testimony. The rule of this Court, in reviewing findings upon conflicting testimony, has been recently stated with great clearness—

> "The trial court's findings in a suit in equity are presumptively correct, and will not be disturbed on appeal, unless an obvious error has intervened in the application of the law, or serious or important mistake has been made in consideration of the evidence especially in a case in which the testimony was taken in open court, so that the trial court had the opportunity of observing the demeanor of the witnesses, while the appellate court has before it only a condensed printed statement of the evidence."

Tobey vs. *Kilbourne,* 222 Fed., 760.

This rule of decision is equally applicable under the new equity rules.

American Rotary Valve Co. vs. *Moorehead,* 226 Fed., 202.

EVEN IF GEORGE H. TAYLOR, IN 1903, HAD NOTICE THAT HARRY M. MARTIN IMMEDIATELY ENDORSED THIS CERTIFICATE OF STOCK AND DELIVERED IT TO HIS MOTHER, THE BANK WAS NOT CHARGEABLE WITH NOTICE OF THAT FACT WHEN IT MADE THE LOAN TO HARRY M. MARTIN.

Neither George H. Taylor nor Fred Stadtmuller became directors of the Washoe County Bank until August, 1909 (Tr., p. 151).

When the Bank made its loan to Harry Martin in the Fall of 1906, George H. Taylor was the confidential agent and bookkeeper of the Martin Estate Company (Tr., pp. 106, 108, 128).

Harry Martin requested George H. Taylor, the confidential agent of the Martins, to make application to the Bank for a loan. This was three and one-half years after the events which it is claimed gave Taylor notice that this stock did not belong to Harry Martin. It is not to be presumed that George H. Taylor, while acting for Harry Martin in securing this loan for him from the Bank, would disclose to the Board of Directors, who alone had authority to make this loan, the information, if any such he possessed, that Harry Martin was not the owner of this stock, because to disclose that information would be in violation of the duty which he owed to the Martin Estate Company and would tend to defeat the very purpose of his application.

The rule that a principal is bound by the knowl-

edge of his agent, acquired in the transaction, or so soon before it that it may be presumed to be remembered by him when subsequently acting for his principal, is subject to the qualification that the information was not obtained under such conditions that it would be a breach of confidence for him to disclose it to his principal, or when, from his relation with the subject-matter, it will not be expected that he will disclose it.

The Distilled Spirits, 11 Wall., 356;
Bank vs. *Thompson,* 118 Fed., 798;
George vs. *Butler,* 50 Pac., 1032;
Melms vs. *Pabst Brew. Co.,* 66 N. W., 522;
Mechem on Agency, Sec. 721.

When Mrs. Martin, in 1903, applied to George H. Taylor, who was then the Assistant Secretary of the Washoe County Bank, to have these fifty shares of stock transferred to the name of Harry M. Martin to qualify him to become a Director of the Bank, the only duty which Taylor had to perform, as an officer of the Bank, was, as Assistant Secretary (for he was then no other officer), to make the proper entries of the transfer and issue the new certificate. In making that transfer he acted for the Bank, but when the transfer was made and the certificate delivered to Harry M. Martin, the transaction was closed. He was in no way concerned in what Harry M. Martin did with the certificate nor the private dealings be-

tween Harry Martin and the other members of his family. The trial judge has very clearly and satisfactorily reviewed this testimony (See Tr., pp. 48-50).

We submit there is no evidence justifying a finding that Taylor at that time knew that Harry Martin was not the owner of this stock or that the Bank was chargeable, when it made the loan in 1906, with any knowledge which Taylor may have had concerning the ownership of this stock in 1903, nor is there any presumption that if he had any such knowledge he conveyed it to the Board of Directors at or before the time the loan was made.

This case concerns a corporation organized under the laws of the State of Nevada. What constitutes notice to a Nevada corporation should be determined by the decisions of that State and, in order to charge the Bank with notice, it must, under those decisions, be shown that *a majority of the Board of Directors,* when they authorized this loan to Harry Martin, had knowledge that he did not own the stock.

Yellow Jacket S. M. Co. vs. *Stevenson,* 5 Nev., 231-233;
Hillyer vs. *The Overman M. Co.,* 6 Nev., 51, 57;
Edwards vs. *Carson Water Co.,* 21 Nev., 483.

Much evidence was offered and received, against, and subject to the objection of the Washoe County Bank, of what took place in 1909 respecting the pay-

ment of dividends, and the conduct of Taylor and Stadtmuller, for the purpose of showing that the Bank had notice, or had waived its right to a lien upon this stock. The objections were made upon the ground that notice to the Bank must have preceded the making of the loan in order to affect its lien and that what took place nearly three years afterwards was wholly incompetent and immaterial, and that under the By-Laws, neither Mr. Bender, Mr. Taylor nor Mr. Stadtmuller had any power to waive the lien of the Bank, the By-Laws expressly providing that the only waiver authorized to be made was the written consent of the President (Tr., pp. 98, 100, 101, 111, 113, 114, 115, 127).

The Answer avers, and the record shows, that the Martin Estate Company never made any demand to have the stock in question transferred from Harry M. Martin to it until July, 1909 (Tr., pp. 16, 119, 151), before which time Mrs. Martin became anxious about the condition of her son's business at Tonopah, and sent George H. Taylor, at her own expense, to investigate it, he being at that time in her employ (Tr., pp. 122, 136).

It was not until after Mrs. Martin had been advised by her nephew, Fred Stadtmuller, that Harry Martin's creditors knew this stock was standing in his name, did she ever make any claim to the Bank that this stock belonged to the Martin Estate Company and that she wanted it transferred (Tr., p. 99).

Before this time the panic came to Tonopah and the property of the Nye County Mercantile Company (the stock of which Company Harry M. Martin had pledged as collateral security for his debt to the Bank) was mortgaged to secure its creditors and, by foreclosure and sale under that mortgage, this collateral security became worthless (Tr., pp. 50, 129, 130). Before that time a dividend had been declared by the Nye County Mercantile Company upon its stock of which, however, the Bank had not received notice. Mrs. Martin also held stock in that Company. The dividend declared upon her stock she received, but that declared upon the stock held by the Bank as security for Harry Martin's loan was credited to surplus account because it did not have ready money to pay it (Tr., pp. 129, 130).

The agreement attached to Martin's note to the Bank expressly said the Bank should not be liable for failure to collect the security, or to sue therefor (Tr., p. 126).

The answer of the Martin Estate Company, in reference to these fifty shares of stock, alleges:

> "That until July, 1909, the dividends were paid in checks drawn to the order of Harry M. Martin, which were sent to him, by him endorsed, and credited to this defendant" (Tr., p. 25).

and the testimony is that after that time, and until 1911 (since which time the Bank has applied the dividend upon this stock to the credit of Martin's

debt to it), the dividend checks were made payable to the order of Harry Martin and handed to Fred Stadtmuller with instructions to mail them to Harry Martin, although the instructions seem not to have been obeyed (Tr., pp. 94, 154).

The fact that the Bank for some time permitted Harry Martin to receive the dividends upon this stock and that the Martin Estate Company got the benefit of it was to their advantage and that the Bank did not assert its lien as soon as it might, certainly raises no equity on behalf of the Estate Company. It was benefited and not prejudiced by it.

It is clear that the taking of additional security by the Bank for the payment of Harry Martin's indebtedness was not a waiver of its lien on this stock. The law to that effect is very clearly stated by Justice Story in *Union Bank* vs. *Laird,* 2 Wheaton, 393-394.

See also

1 *Boles on Banking,* Sec. 27, page 90;
3 *Clark and Marshall on Corporation,* 771;
Kenton Ins. Company vs. *Bowman,* 1 S. W., 717-720;
Germ. Natl. Bank vs. *Ky. Trust Co.,* 40 S. W., 458;
Kilpatrick vs. *K. C. & B. H. Ry. Co.* (Neb.), 57 N. W., 664-671.

The mere failure to assert a lien is not a waiver of it. In order to constitute a waiver, there must be

either an intention to waive, or such conduct as will estop the person having the lien from claiming it.

3 *Clark and Marshall on Corporations,* 171.

When the request was made to have this stock re-transferred to the Martin Estate Company, the indebtedness of Martin to the Bank and its lien under the By-Laws upon this stock were given as the reason why the transfer could not be made (Tr., pp. 112, 122, 150).

The certificate provided how the waiver could be obtained. No other waiver could rightfully be made. A party claiming a waiver has the burden of proving it, and the evidence should make a clear case.

40 *Ency. of Evidence,* page 269.

Not only did the Martin Estate Company cause this stock to stand upon the books of the Bank in the name of Harry M. Martin and not make any claim of ownership or demand for its transfer until after the other security held by the Bank had become worthless, and it became apprehensive that the stock might be seized by his creditors, but it also knew that this stock was being voted at the stockholders' meeting either by Harry Martin in person, or by his proxy, as being the stock of Harry Martin, and at a meeting of the stockholders held July 9th, 1907 (Tr., pp. 131, 132), Mrs. Martin represented this stock as the proxy of Harry Martin and, at other meetings held in July,

1909, and July, 1910, the fifty shares of stock standing in the name of Harry M. Martin were represented by his proxy to the Martin Estate Company (Tr., pp. 132, 133).

It is assigned as error that the trial Court did not indulge in a presumption that if George Taylor had been called, his testimony would have been unfavorable to the Bank. How this constitutes an error at law which can be made the basis of an assignment does not appear. It is, however, shown by the record that George H. Taylor was not only always friendly to the Martins and for many years their confidential agent, but that in 1909 he told Mrs. Martin "that if it ever came to a law suit, he would have to testify for the W. O'H. Martin Estate" (Tr., pp. 117, 128, 106, 108). It thus clearly appears that George H. Taylor was not hostile and was equally available by the Martin Estate Company as a witness in this behalf, and had said that he would have to be such, in the event of a law suit. In such a case the rule is very clear, that there is no presumption that his testimony would be adverse to the Bank.

> *Greenleaf on Evidence,* 16th ed., Sec. 195(b); *Jones on Evidence,* Sec. 21.

Notwithstanding the points are not covered by the assignment of error the appellant has argued questions of the Statutes of Limitation and marshaling of assets. It should be sufficient to say that the record

does not present these questions because they are not assigned as error, but the doctrine of the marshaling of assets is wholly inapplicable and the rule in reference to the Statutes of Limitation invoked by the appellant and supported in the main by a California decision, is not the rule in Nevada.

Richards vs. *Hutchinson,* 18 Nev., 215;
Harding vs. *Elkins,* 29 Nev., 329;
Hanchett vs. *Blair,* 100 Fed., 817.

It is respectfully submitted that the judgment should be affirmed.

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